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China's Economy in 1985: A Test for Reform and Reformers

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China's Economy in 1985: A Test for Reform and Reformers

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A Research Paper

This paper was prepared by [] Office of
East Asian Analysis. Comments and queries are
welcome and may be directed to the Chief, China
Division, OEA []

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**China's Economy in 1985:
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Summary

*Information available
as of 15 May 1986
was used in this report.*

Problems associated with the implementation of major economic reforms arose in full force in 1985, severely testing the economic skills and political resolve of China's reformers. According to Chinese statistics and press reports:

- Confusion surrounding new agricultural policies was compounded by poor weather, causing grain output to fall for the first time in five years.
- Industrial output, spurred by economic incentives and relaxed central controls, grew at an excessive 18-percent rate, increasing the strain on China's inadequate infrastructure.
- Inflation tripled, the trade deficit grew to almost \$7 billion, and foreign exchange reserves declined 29 percent.
- Low-level officials took advantage of relaxed controls to engage in price gouging, speculation, and fraud.

Although industrial production has slowed since July, Beijing remains concerned with inflation, excessive investment spending, and the large trade deficit. In major speeches in early 1986, Chinese leaders called for a period of consolidation and adjustment in the reform program, and Premier Zhao Ziyang stated in January that no major price reforms would be implemented this year. Reform leaders emphasize that the readjustment period will be temporary, and they have indicated that important reforms are being contemplated for 1987. For this year, however, we look for the Chinese to try to curb imports and expand exports; make more selective use of foreign exchange reserves; increase incentives for grain production; and emphasize efficiency, profitability, and specialization in industry.

Beijing's success in making these adjustments will have important implications for China's economic relations with the United States. Because of China's large trade deficit and declining foreign exchange holdings, Beijing will push hard for increased sales to the United States of oil, light manufactures, and textiles. In addition, China may restrain domestic consumption and try to increase exports of corn and soybeans to Japan, South Korea, and the Soviet Union—making small, but noticeable inroads into traditional markets for US grain. Planned restrictions on imports of consumer durables and production lines that process foreign-supplied components will probably have a greater impact on East Asian trading partners than on the United States; the Chinese will continue to purchase technologically advanced industrial equipment from US suppliers.

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To conserve foreign exchange, China has also decided to slow or postpone major infrastructure projects—such as construction of a nuclear power plant near Shanghai—for which US firms expected to compete. And increased restrictions on the use of foreign exchange may make joint ventures with China less attractive to US investors.

Finally, Beijing appears resigned to cover part of its expected trade deficit with increased commercial borrowing from the world financial market. At a meeting in March with US Embassy officers in Beijing, Chinese banking officials stated that the government was willing to increase China's debt service ratio from the current 5 to 7 percent to 15 percent by 1990—implying that China might borrow more than \$25 billion over the next five years. Increased Chinese commercial borrowing would provide new opportunities for US banks to benefit from Beijing's opening to the West, as well as greater competition for international investment funds.

The success of the economic adjustment period will also have important implications for the political strength of the reform coalition. Reformers are under pressure from party opponents to show better results from their policies. When the extent of economic problems became evident last year, tensions within the leadership rose quickly—with conservatives attacking Deng Xiaoping and his supporters for excessively decentralizing economic decision making and weakening the role of central planning. Reform leaders acknowledged the economic problems, but defended the reforms and pointed to significant gains during the year—such as an estimated 11- to 12-percent increase in real GNP, an 8-percent jump in energy production, and a sharp increase in government revenues that allowed Beijing to record a budget surplus for the first time since 1978.

Conservatives thus were not able to exploit economic difficulties for political gains, but the pace of reform, nevertheless, slowed sharply during the latter part of the year. Popular disenchantment with the reform program surfaced in the form of protests by university students and grumbling about rising food prices. In our view, Beijing's greatest single challenge will be to maintain price stability, if it is to keep the conservatives at bay and implement further reforms in 1987.

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We believe there is a better-than-even chance that Beijing will be able to slow economic growth and ease pressure on prices, thereby setting the stage for reforms next year. But because Chinese leaders lack experience managing a partially decentralized economy, and because pressures for rapid growth exist throughout the country, we expect China will continue to experience periods of excessive growth and inflation—followed by government-induced retrenchment—as Beijing implements additional reforms. The fluctuations in China's economic growth, in turn, will impart a "stop and go" character to Beijing's reform program during the next five years.

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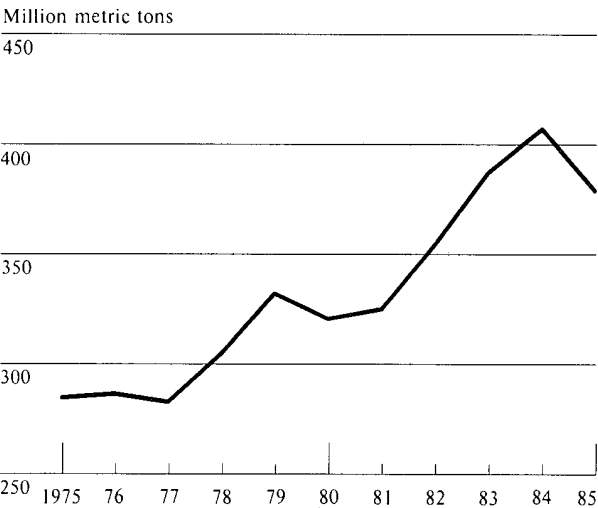
China's Economy in 1985:
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Reforms and Economic Performance

China's economic performance in 1985 was driven by the expanded economic reform program adopted by the Central Committee in October 1984. Relaxed central controls sparked significant gains in production, but economic policy makers had difficulty steering the economy through the transition to a more market-oriented system. Reform-related problems became embroiled in the party and government debate over the Seventh Five-Year Plan (for 1986-90)—the draft of which was approved in April by China's National People's Congress (NPC). Although the draft reaffirmed China's commitment to economic reform, Beijing has announced that 1986 will be a year for consolidating and improving past policies. Beijing's ability to reestablish economic stability this year will play a key role in determining reform policies for the rest of the plan period.

Figure 1
China: Grain Production,
1975-85



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Shifting Patterns of Agricultural Production

Since the economic reforms were launched in 1979, agriculture has been the centerpiece of Beijing's effort to improve economic efficiency. Although agricultural reforms are still the most important success of the reform program—the gross value of agricultural output increased at an average annual rate of 11 percent from 1981 to 1984—growth rates fell in 1985. According to China's State Statistical Bureau, agricultural output increased only 3 percent last year.¹

After three consecutive years of record harvests, grain output fell 7 percent in 1985 (see figure 1)—as a result of reduced acreage, flood damage, and confusion over reforms that eliminated grain quotas in favor of a market-oriented contract system. Rapidly developing rural industries also pulled peasants away from less

¹ The growth rate for 1985 excludes the production of village industries—formerly counted as agricultural output.

lucrative grain production.² Reform leaders maintain, however, that surpluses from previous years will more than make up for the shortfall.

Notwithstanding the smaller harvest, China became a net grain exporter in 1985. According to Chinese trade data, China exported over 9 million metric tons of grain last year—almost triple the 1984 level.

Chinese grain imports were approximately 5.4 million tons—with about 800,000 tons coming from the United States (see figure 2).

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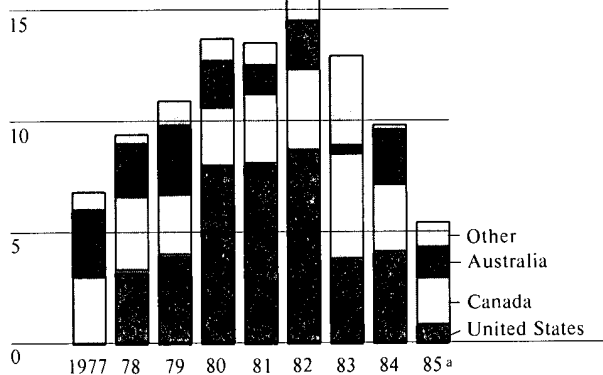
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Figure 2
China: Imports of Grain,
by Source, 1977-85

Million metric tons

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^a Estimated.

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Efforts to diversify agricultural production were bolstered by officially sanctioned price hikes. Outputs of sugarcane, peanuts, rapeseed, and sesame increased by more than 25 percent last year, according to Chinese press reports. Production of meat increased by 14 percent, and eggs by 23 percent. [REDACTED]

Overly Rapid Industrial Growth

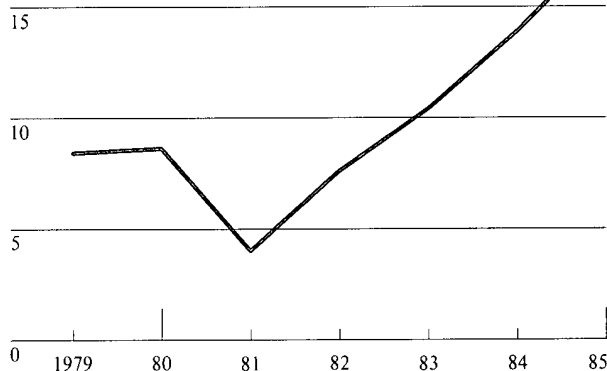
China's industrial output increased 18 percent last year, according to Chinese statistics, continuing a trend of double-digit growth in industrial production that began in 1983 (see figure 3). During the first half of 1985, industrial output expanded at a 23-percent annual rate, but efforts to cool the economy reduced the growth rate to 10 percent in the fourth quarter³ (see figure 4). [REDACTED]

³ Industrial output increased at an annual rate of 4.4 percent during the first quarter of 1986. [REDACTED]

Figure 3
China: Growth in Industrial Output,
1979-85

Percent

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Rural industry was the fastest growing sector of China's economy for the second year in a row. Chinese media reported that the output value of rural factories shot up by 35 percent and accounted for almost one third of total industrial production. In light industry, buoyant consumer demand sustained a boom in the production of electrical home appliances. Output of washing machines, electric fans, and television sets increased over 50 percent, and production of refrigerators more than doubled. Production of building materials, heavy equipment, and machinery generally increased more than 15 percent during the year, while production of rolled steel increased about 9 percent. [REDACTED]

We believe, on the basis of incomplete statistical evidence, that rapid industrial growth has been caused by skyrocketing investment spending—up by 35 percent in 1985—and a surge in wages and bonuses for [REDACTED]

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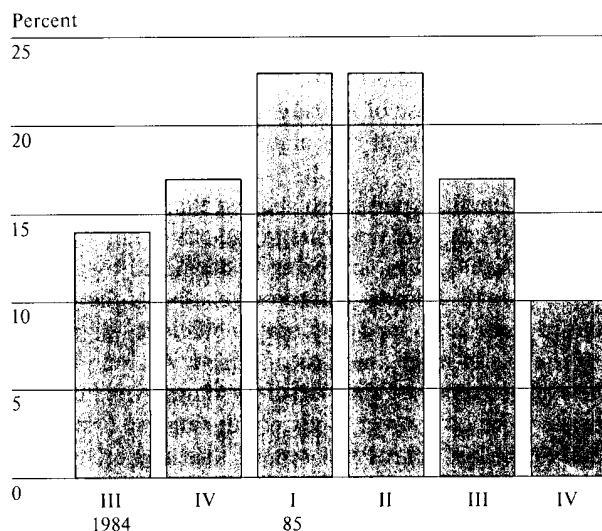
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Figure 4
China: Growth in Industrial Output,
by Quarter^a



^a Annual rate.

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industrial workers. Successful rural reforms have increased the availability of raw materials for industrial use, while boosting rural incomes and fueling consumer demand. Rapid industrial growth also has been facilitated by industrial reforms, particularly those allowing enterprises to sell overquota production at prices above the state-set levels. To a lesser extent, rapid growth last year may have been caused by the technical modernization of some segments of Chinese industry—such as steel, textiles, and electronic products. []

Significant Gains in Energy Production

China's production of both coal and electricity increased about 8 percent last year, and oil output grew 9 percent.⁴ China was the world's second-largest coal producer in 1985, with output topping 850 million []

tons. Recent gains in production have been the result of policies that eased restrictions on private and collective small-scale mining operations, that permitted state mines to sell overquota production at free market prices, and that rewarded workers for increased productivity. []

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China produced about 2.5 million barrels of oil per day (compared with 2.3 million in 1984), exporting one-fourth of the total. Gains in oil production were a result of new finds and improved recovery technologies. Increases in electric power generation came largely from completion of new coal-fired facilities and increased deliveries of coal to power plants. []

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Burgeoning Trade Deficit

Loosened central oversight of foreign trade and a surge in investment and consumer spending led to a flood of imports—up 54 percent last year, according to our estimates based on partner trade data. Because of the surge in domestic production, Chinese exports increased by about 13 percent—leaving Beijing with a 1985 trade deficit of \$6.9 billion.⁵ Because of the deficit, China's foreign exchange reserves fell by almost one-third during 1985, and China devalued its currency about 12 percent against the US dollar (from 2.8 yuan/dollar to 3.2 yuan/dollar).⁶ []

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⁵ Customs data reported by China's State Statistical Bureau show exports increasing less than 5 percent last year, giving China a trade deficit of \$14.9 billion. The discrepancy between Chinese customs data and partner trade data results, in part, from differences in accounting practices. First, China's customs data includes the costs of insurance and freight in its import totals, and excludes them from its export totals—which inflates the reported trade deficit. Using International Monetary Fund methodology to exclude the costs of insurance and freight from import values, China's trade deficit would be \$11.4 billion. Second, we believe that China includes in its import totals payments for certain services—such as training, blueprints, and royalties—that are related to capital goods imports. This may inflate China's reported trade deficit by over \$1 billion, relative to partner trade data. In our judgment, the discrepancy between Chinese customs data and partner trade data may also result from attempts by Chinese traders to circumvent their customs service through smuggling, underreporting the value of their exports, and overreporting the value of their imports. []

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⁶ China's currency is inconvertible. The State Administration of Exchange Control (an organ of the central bank) adjusts its value according to a trade-weighted basket of major currencies. []

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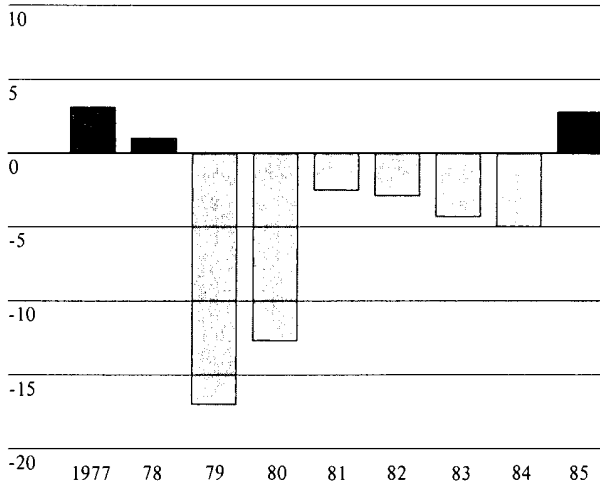
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Figure 5
China: Budget Deficits and Surpluses,
1977-85

Billion yuan



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Improved Budget Picture

Strong industrial growth, rising prices, and increased tariffs on some imports pushed up government revenues by over 24 percent in 1985, despite difficulties—including widespread tax evasion—in implementing a new tax system. The gains in revenue allowed Beijing to record a budget surplus of 2.8 billion yuan (\$880 million), the first since 1978 (see figure 5). Chinese accounting practices, however, record government bond sales and Ministry of Finance foreign exchange borrowing from Chinese banks as revenue. As measured by Western standards, China's budget had a deficit of about \$2.7 billion dollars.

Problems With Rapid Growth

Although Chinese leaders tout rapid growth as an indicator that industrial reforms are working, media commentaries suggest that Beijing is concerned that a continuation of the fast-paced expansion will exacerbate longstanding economic problems, heighten social

tensions, and undermine reform efforts. Despite the sharp increases in production of coal, oil, and electricity last year, energy supplies in China are strained. Additions to the transportation network have not kept pace with the growth in industrial output, and the system remains seriously overburdened. Chinese media report that factories still must suspend production frequently because of shortages of electricity and delayed shipments of raw materials.

Chinese media reports also suggest that key reform goals, such as improvements in industrial efficiency and product quality, are being undermined by the rapid growth. Beijing acknowledges that higher output in some cases is caused not by efficiency gains but by the use of large amounts of inputs. A Hong Kong newspaper reported that losses by state-owned enterprises were up by over 9 percent during the first nine months of last year. Press reports also suggest that rapid growth is wearing out equipment at excessive rates, increasing occupational hazards in factories, and generating higher levels of environmental pollution.

in March 1986, Premier Zhao Ziyang acknowledged that recent output levels were possible only because China imported large amounts of raw materials and industrial components. Imports of rolled steel last year, for example, were equivalent to one-half of China's total rolled steel production, yet China's machinery industries experienced shortages of rolled steel—as well as pig iron, copper, zinc, and other raw materials—during the year. We believe Beijing recognizes that its industrial development cannot be based on imports of raw materials and equipment, and that its foreign exchange holdings cannot sustain such high rates of growth.

When their accelerated reform program was approved in 1984, reformers claimed that increased competition between state-owned enterprises would spur improvements in the quality of products. The shortages caused by strong demands for consumer and investment goods, however, have actually eased pressure on firms

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to maintain quality standards. []
Zhao admitted that poor quality remains a "fatal weakness" of China's economy. []

Although output grew rapidly in 1985, it was not sufficient to meet the demand for consumer durables, industrial equipment, and building materials. China's retail price index showed prices rising 8.8 percent, triple the rate in 1984. Beijing probably is concerned that rising prices will jeopardize popular support for economic reforms. Although large increases in wages and bonuses have cushioned the impact of higher prices for some consumers, a jump in retail food prices caused widespread complaints among urban residents, and the rising cost of living was a factor in protests by university students last fall. []

Measures To Slow Growth

When the extent of the economic problems became known last year, political tensions within the leadership rose—with conservatives attacking reform leaders for economic mismanagement. We believe that the political strength of the reform coalition and the increased economic sophistication of its leaders was evident in Beijing's reaction to the economic problems in 1985. Chinese leaders did not halt reforms and try to dampen the overheated economy abruptly by reimposing strict administrative controls—as they might have in the past. Instead, after industrial output increased at a 23-percent annual rate during the first quarter of 1985, they implemented a combination of market-oriented macroeconomic adjustments and state directives to slow the economy gradually. []

China's 1985 budget, announced that April, called for narrowing the budget deficit by slowing the growth of government spending. In particular, Beijing ordered a 10-percent cut in administrative expenditures. Beijing also began pursuing a tight money policy:

- In April, Beijing raised interest rates on time deposits and on loans for working funds. In August, Beijing boosted rates on capital construction loans and again hiked time deposit rates.

- Lacking an established secondary market for government securities, China's central bank cannot conduct open market operations. Instead, Beijing reduces the money supply by increasing sales of goods from state-run stores. To soak up excess currency, Beijing announced that it would use \$2 billion in foreign exchange reserves to import scarce consumer durables,⁷ and the Ministry of Commerce was ordered to mark down prices of overstocked domestic commodities and increase sales to the public. Banking authorities also made vigorous efforts to collect savings deposits from households—including mobile bank teams that went door to door. []

To slow growth, Beijing ordered a halt in some capital construction projects. Many other administrative controls were employed through China's banking system:

- According to official statements, China's central bank was ordered to set and enforce quarterly credit limits for its branches and the specialized banks (such as the Agricultural Bank and the Industrial and Commercial Bank).
- Banks were ordered to stop offering loans to inefficient enterprises and to firms that produce poor-quality products.
- Banks were prohibited from extending credit for capital construction projects whose spending exceeds the state quota or for projects not listed in the state plan.
- To prevent indiscriminate increases in wages and bonuses, enterprises were required to place wage funds in special accounts to be monitored by the banks. Apparently, the payroll accounts of some units were frozen. []

⁷ Although conclusive evidence is lacking, the \$2 billion foreign exchange set aside may have been announced, in part, to put a better gloss on the surge in imports of consumer durables that was already under way. []

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How Reliable Are Chinese Statistics?

Western economists have been cautious about accepting Chinese economic statistics at face value. Like those of most developing countries, China's statistical collection and measurement techniques are crude, and economic data sometimes are deliberately distorted at local levels. Our concerns with the reliability of Chinese statistics have been heightened in the past year by the very rapid industrial growth rates reported by Beijing and by the sharp changes in values of other economic indicators, such as the trade balance and foreign exchange reserves. []

Although we generally have confidence in gross production statistics for individual products—particularly in heavy industry—we believe recent figures may overstate Chinese industrial performance for a number of reasons:

- *Enterprises increasingly purchase semifinished goods and industrial components from other firms rather than manufacture the inputs themselves, and these transactions may be recorded in calculations of overall industrial output.*
- *Although industrial output in urban areas is measured in constant prices, the output of rural industries is not adjusted for inflation.*
- *On occasion, production data may be exaggerated by local officials and enterprise managers.*

Nevertheless, we believe the economy grew at a very rapid pace last year, albeit more slowly than Chinese figures indicated. []

We also have noticed some anomalies in other economic data released by Beijing:

- **Cotton.** *Beijing implemented policies last year to reduce cotton production, and China's State Statistical Bureau reported a 33-percent drop in output. On the basis of weather patterns and acreage planted, however, we believe the actual decrease was less than Beijing reported.*
- **Trade Balance.** *China's Customs Bureau and the Ministry of Foreign Economic Relations and Trade each publish an estimate of China's balance of trade. The two estimates for 1985 differed by over \$7 billion (neither accorded with projections based on partner trade data). Although each calculation is based on different accounting methods, the difference between the estimates appears to have widened more than can be explained by the growth in China's trade.*
- **Foreign Exchange Reserves.** *Last year, Beijing apparently changed the way it calculated foreign exchange reserves to include its holdings of foreign government securities. Although not officially acknowledged by Beijing, the change does explain why China's foreign exchange reserves appeared to increase \$1.7 billion between June and September even though trade deficits (according to Chinese customs figures) averaged about \$1 billion a month during the quarter.* []

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Although industrial production has slowed since mid-1985, statements by Chinese leaders at the recent NPC suggest to us that Beijing remains very concerned with inflation, excessive investment spending, and its large trade deficit. We believe Beijing will continue to tighten control over credit and capital construction this year. []

Economic Corruption: A Growing Concern

In addition to macroeconomic problems, Beijing has been confronted with rampant economic corruption, with some of the worst cases caused by party officials. Although Chinese leaders probably expected that an increase in economic corruption would accompany a

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In our judgment, the reliability of Chinese statistics may have been eroded somewhat by recent economic decentralization, China's statistical reporting system was set up to measure the performance of a planned economy, but economic reforms have decreased the portion of the economy operating under direct state controls. Beijing may be having difficulties accurately recording and valuing outside-of-plan production and the output of rural industries. [redacted]

We believe China's top officials probably do not deliberately distort economic statistics. Beijing, however, is not above "packaging" data for political purposes. For instance, last year Beijing announced that the output of village industries would henceforth be included in the total for gross value of industrial output (GVIO), instead of in the total for gross value of agricultural output (GVAO)—as had been the case. When the 1985 State Statistical Communique was released, however, the output totals presented first were calculated according to the old system. Because village industries were the most rapidly growing sector in China's economy, their inclusion in the GVAO statistic made agricultural and industrial growth appear better balanced. In other press reports, statistics for GVIO have been presented without qualification as to whether village industries are included in the totals. [redacted]

Notwithstanding the potential problems with Chinese accounting methods, we report official statistics for the following reasons:

- *We believe Chinese leaders base decisions on the official data that is released publicly. Although leaders undoubtedly receive confidential reports on economic performance, we believe the government does not have a separate data set that is markedly more accurate than the information released by the State Statistical Bureau. Changes in the values of official economic statistics often provide us a means to predict accurately changes in Beijing's economic policy.*
- *We believe growth rates give accurate qualitative indicators of economic performance. For instance, Chinese price indexes probably understate inflation, but changes in the indexes may generally reflect the inflation trend.*
- *Sometimes we are able to verify official statistics indirectly. Reported gains in oil production, for instance, correspond with increases in Chinese oil exports (which can be verified from partner trade data).*

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We believe official statistics, when interpreted with some caution, provide a generally accurate picture of economic trends in China. [redacted]

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loosening of central controls, they may have been startled by the extent of the problem. During the past year, the Chinese media have reported numerous examples of illegal price hikes, fraud, bribery, smuggling, and black market trading of foreign currencies. Three of the most egregious cases uncovered by Beijing were:

- *The Hainan Island Case.* Island authorities took advantage of development policies that allowed

tariff-free imports of some products to purchase Japanese cars, television sets, and other consumer durables and illegally resell them in the interior of China. Before central authorities stepped in, Hainan entities had arranged to import almost \$1 billion worth of cars. On the basis of reports by the Hong Kong media, we believe that broad elements of the party, government, and military forces took part in the scheme.

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- *The Fake Medicine Case.* In one prefecture in Fujian Province, 45 enterprises manufactured counterfeit brand-name medicines, which were marketed throughout China. According to press reports, local officials protected the counterfeiters for over two years. The case was judged to be so serious that it was mentioned in a major speech at a national party conference in September 1985.

- *The Liu Haoran Case.* An itinerant ex-convict set up a dummy trading company and, in less than six months, signed fraudulent contracts worth 7.85 billion yuan (almost \$2.5 billion) with Chinese organizations. Promising to deliver scarce goods in return for a down payment, Liu collected more than 19.7 million yuan (over \$6 million).

Last year Beijing also combated a proliferation of companies established by party and government officials. Chinese media reported that these officials used their influence to obtain goods in short supply and reaped windfall profits by marking up prices. In one case, local officials threatened a bank manager with loss of party membership if he did not lend them money for their company. Recently, the Hong Kong press has reported that children of senior officials have been involved in illegal dealings while managing large Chinese trading companies.

Conservative Opposition to Reform

Party conservatives—with Politburo Standing Committee member Chen Yun the rallying point—took advantage of economic problems to press Deng Xiaoping to slow the pace and narrow the scope of reforms. In May 1985, a party newspaper for intellectuals published a series of articles that drew parallels between the rapid growth China was experiencing and the 1958-60 Great Leap Forward—which Chen had opposed. Two months later, the party theoretical journal published an incendiary article that praised Chen's leadership of the economy in the 1940s and 1950s and disparaged current decisionmaking on economic policy. Chen delivered a sharp public criticism at a party conference in September, warning that the fall in grain production threatened economic stability. Chen also rebuked reformers on theoretical grounds,

arguing that “market regulation involves no planning, blindly allowing supply and demand to determine production . . . planning is the essence of macroeconomic control.” In a broader sense, Chen's argument implied that economic reforms were progressing too rapidly and that there are limits on how far economic decentralization can go without threatening social disorder.

Readjustment and Consolidation

Although Deng was able to weather the storm—at the September party conference, in fact, he was able to make sweeping personnel changes that strengthened his reform coalition—conservative criticism clearly was a factor in the marked slowdown of the pace of reform. Premier Zhao stated in January 1986 that no major price reforms would be implemented this year, and in his speech to the national party conference in September 1985 suggested that Beijing might need a two-year readjustment period to perfect macroeconomic control techniques. Other leadership statements and press reports indicate that through the end of this year the Chinese will:

- Adjust agricultural policies to boost grain production. Beijing will increase state investment in agriculture and make subsidized fertilizer and fuel available to peasants who grow grain.
- Widen slightly the scope of managerial autonomy. Firms that produce goods for export, for example, will be encouraged to retain a portion of their foreign exchange earnings for use in improving production technology.
- Promote efficiency and profitability through specialization and interenterprise trade.
- Make minor price adjustments. Policies linking total wage funds and enterprise profitability probably will be delayed pending further price reforms.

We believe this period of adjustment will be smoother than the 1979-80 cycle of reform and readjustment

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that led initially to a surge of imports, investment spending, and inflation—and later to arbitrary cancellations of import contracts for industrial plants and sharply reduced spending for important infrastructure projects. First, central leaders are now more knowledgeable about how China's economy operates and what is economically feasible. Second, production of agricultural, and light and heavy industrial products is much better balanced than before, the government has a budget surplus, and foreign exchange holdings are much higher. Finally, Beijing can use indirect economic levers, as well as administrative controls, to restore economic stability. []

Impediments to Future Stability

Beijing's ability to reestablish economic stability in 1986 will weigh heavily in determining reform plans for the rest of the decade. Managing an economy that is being transformed from a centrally planned system to one that mixes planning and market elements, is difficult, however, and the factors responsible for economic dislocations last year still exist. []

Policy Errors

Major sources of economic instability in 1985 were the 50-percent increase in currency in circulation and loans to industrial enterprises that were made in 1984. In our view, the money supply surge was caused by errors in the implementation of new banking reforms. Although a period of consolidation may allow Beijing time to plan the next steps in reform, the pragmatic, trial-and-error nature of China's reform process makes similar mistakes almost inevitable. []

One-Sided Enterprise Autonomy

Although managers have more flexibility in using enterprise revenues, reforms have not progressed far enough to allow market forces to discipline managers who make poor choices. Beijing still subsidizes state enterprises that lose money, and a working group was formed only recently to draft bankruptcy legislation. Until the industrial reform program is implemented fully, a further relaxation of administrative controls over enterprises probably will cause another surge in capital construction and wage payments. []

Local Interests

Reports in national and provincial media suggest that enormous pressure by workers, managers, and local officials for rapid growth is a continuing source of economic instability. Promotion of "10,000 yuan households" by the media in 1984 and exhortations to get rich through hard work have generated rising expectations among workers for an improved standard of living. Rising food prices have intensified worker demands for raises, while the relaxation of state controls over some enterprises has weakened the ability of managers to resist them. Given years of emphasis on meeting quantitative targets, many managers still believe that they must prove their competence by rapidly expanding enterprise production. []

Chinese leaders have made clear they will increase the powers of the central bank and make greater use of taxes to maintain economic stability while implementing reforms. But because they lack experience in managing a partially decentralized economy, and because pressures for rapid growth exist throughout the country, we expect China to experience periods of rapid growth and inflation—followed by government-induced retrenchment—as Beijing implements its reform program.⁸ The fluctuations in China's economic growth, in turn, probably will impart a "stop and go" character to Beijing's reform program during the next five years. []

Implications for the United States

Because of China's large overall trade deficit and declining foreign exchange reserves, Beijing probably will push hard for increased exports this year—including greater sales to the United States of oil, light manufactures, and textiles. China may restrain domestic consumption and try to increase exports of corn and soybeans—primarily to Japan, South Korea, []

⁸ The difficulty of managing China's economy is compounded because the responsiveness of enterprises and consumers to economic levers probably is changing as the reforms proceed. []

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and the Soviet Union. We believe China will continue to make noticeable—but minor—inroads into traditional markets for US grain in 1986. []

[] this year, Premier Zhao indicated that Beijing will try to slow the growth of imports while changing the composition of China's purchases. According to Zhao, Beijing will strictly control imports of consumer durables and production lines that process foreign-supplied components. Restrictions already are in place for consumer durables that China can produce domestically, including color televisions, refrigerators, radios, and motor vehicles. These restrictions will probably have a greater impact on sales by East Asian trading partners than on sales by the United States. Despite the lower harvest in 1985, grain reserves and increased production this year probably will be sufficient to prevent Beijing from increasing grain imports by much in 1986. Beijing's ability to cut back overall imports is somewhat limited, however, by the continuing need for raw materials and technologically advanced equipment for Chinese industries. []

Faced with the prospect of a trade deficit in 1986, Beijing is attempting to be more selective in expending foreign exchange reserves. For instance, Beijing apparently has decided to slow or postpone major infrastructure projects—such as construction of a nuclear power plant near Shanghai—for which US firms expected to compete. Increased restrictions on the use of foreign exchange may make joint ventures with China less attractive to US investors. []

Beijing seems resigned to covering part of the expected trade deficit with increased commercial borrowing from the world financial market. At a March meeting

with US Embassy officers in Beijing, Chinese banking officials stated that the government was willing to increase China's debt service ratio from the current 5 to 7 percent to 15 percent by 1990—implying that China could potentially borrow more than \$25 billion in the next five years.¹⁰ In 1985, China issued over \$800 million of foreign-currency-denominated bonds for public subscription outside of China, and we expect Beijing to step up these sales this year. Increased Chinese commercial borrowing will provide new opportunities for US banks to benefit from Beijing's opening to the West, as well as greater competition for international investment funds. []

In the long run, commercial opportunities for US businesses are linked to Beijing's success in implementing its ambitious reform program, and, therefore, to its ability to prevent the instability that plagued the economy last year. Prospects for increased US sales to China are dependent to some extent on China's ability to earn foreign exchange. Improved Chinese export performance, however, ultimately must be achieved through improvements in industrial efficiency elicited from reforms of production and industrial management systems. Controversial price reforms are necessary to improve resource allocation in China and are the keys to allowing China and its trading partners to benefit from increased specialization according to comparative advantage. [] in March, Chinese officials hinted that they eventually plan to make China's currency freely convertible, and thus eliminate foreign investors' concerns regarding repatriation of profits. Beijing probably anticipates, however, that currency convertibility can be allowed only after the reform program has been implemented fully. []

¹⁰ Some of the borrowing, of course, would be noncommercial borrowing from international organizations and other governments. []

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Appendix

A Report Card on Economic Reforms

The Third Plenum of the 12th Party Congress, which met in October 1984, approved a general set of guidelines for expanding China's economic reform program to urban areas. During the first half of 1985, Beijing announced initial steps toward price and wage reforms, while promoting increased autonomy for industrial enterprises. In 1985, Beijing also took a major step toward commercializing agriculture. We believe the economy has responded strongly to the reforms, but not always in ways that Beijing anticipated. []

Second-Stage Agricultural Reforms

Seven years ago Beijing introduced the "household responsibility system," which gave peasant families effective control, but not ownership, of farmland. The system allowed peasants to lease land for a fixed period—now 15 years for most uses—and gave them leeway to manage the land as they wanted. Peasants, in return, had to meet production quotas but could sell overquota output to the state at premium prices. To encourage greater production, in the spring of 1979 Beijing raised procurement prices of all major farm products (but maintained retail prices at previous levels). []

The success of the reforms probably surprised Beijing—grain production increased at an average rate of over 6 percent per year from 1979 to 1984. The agricultural policies, however, began to impose a financial burden. Beijing had to lay out increasing amounts of budget revenues to purchase the bumper harvests, while produce rotted in overflowing state granaries. []

To reduce the financial burden of successful reforms, Beijing implemented policies in 1985 that broadened the influence of market forces on agriculture. Instead of setting mandatory purchase quotas for peasants to fulfill, the state now signs production contracts for

grain (and cotton) with individual farmers. The contracted amounts generally are less than the previous quotas, and peasants are expected to sell surplus production on the free market. The state has dropped its former commitment to purchase all overquota production at a premium price, and will now purchase excess grain only if the free market price falls below the set procurement price. In addition, the state no longer purchases nonstaple products such as vegetables, fruit, or meat—but state-owned marketing units in cities are being encouraged to sign contracts with peasants to improve supplies of nonstaples in urban areas. Finally, rural industry is being promoted to absorb some of the excess labor created by increasingly efficient agricultural production. []

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Beijing hoped the new policies would promote the development of a diversified agricultural sector and encourage peasants to produce better quality products and make more efficient use of land. The policies, however, elicited a stronger response than Beijing intended. Peasants were quick to switch to more profitable crops, such as oilseeds and vegetables. Strong consumer demand and readily available funds spurred the development of rural industries. According to one Chinese journal, workers on average made three times more in rural industries last year than in traditional agricultural pursuits—and some peasants left their land idle to take jobs in industry. We believe that about 60 percent of the 1985 decrease in grain production can be attributed to the new rural policies. []

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Reforms of Enterprise Management

China's reform leaders believe that granting enterprise managers increased decisionmaking autonomy is the key to reducing the waste and inefficiency that have traditionally plagued Chinese industry. On one hand, Beijing is diminishing the scope of central planning. Only about 60 major industrial products—such as steel, petroleum, and chemicals—are to remain under mandatory state production quotas. Most

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goods eventually will be produced under "guidance" plans that are set by the state but are flexible enough to enable enterprises to adjust to changing market conditions. Although individual managers will have an element of choice under guidance planning, the state intends to maintain overall compliance by adjusting economic levers such as enterprise taxes and interest rates on loans. Some consumer items and many agricultural products will be traded in essentially open markets. []

On the other hand, Beijing is attempting to reduce the control of party and government officials over economic decision making in factories. Enterprises now retain a larger share of their revenues, and managers have more leeway to develop production and marketing strategies and decide how to use retained earnings. In 1984 enterprises were given the right to sell overquota industrial production at prices above state-set levels. Enterprises are encouraged to compete, and managers increasingly are held accountable for losses. []

Chinese media claim that output has increased markedly in some factories in which managers have been given enhanced decisionmaking authority. We believe that the right to market overquota production has been a particularly strong lever for increased efficiency and production. Embassy and press reports, however, suggest that the implementation of increased enterprise autonomy has been uneven. In many factories, party officials or higher administrative units still make the important decisions. Moreover, when managers have decisionmaking authority they are sometimes hesitant to use it. For instance, managers who have the right to fire unproductive workers almost never do. []

Price Reforms

China's price system is irrational in that prices of many goods do not reflect relative market scarcities or the costs of production. State-set prices have been changed infrequently since the 1950s, and some goods are piled up in inventories while others are in chronic shortage. Within the next five years, Beijing plans to establish a more rational, three-tiered price system. Prices of key products, such as coal and steel, will still be set by the state, but at levels that better reflect

relative scarcities in the economy. Prices of many other products, including most manufactures, will fluctuate in response to market conditions within bounds set by the state. Supply and demand alone will determine the prices of minor consumer goods—for instance, some clothing products, cosmetics, and vegetables—and overquota production of most industrial goods. []

Beijing took a cautious approach to price reform in 1985. The key reform implemented was the removal of controls on retail prices of vegetables, meat, and other nonstaple farm products. Beijing also removed price controls on sewing machines, watches, and some brands of bicycles, and—to encourage greater use of highway transport—raised short-haul railroad rates for passengers and freight. []

Although Chinese media report that the reforms have prompted gains in efficiency, higher prices—particularly for food—have sparked widespread complaints. Because the planning system generally kept inflation low in the past, consumers and Chinese leaders are sensitive to price hikes. Reform leaders realize that if they relaxed price controls on additional products the current excessive demands for consumer and investment goods would boost the inflation rate, so they have postponed major price reforms until after 1986. []

Wage Reforms

Chinese reformers, recognizing that Maoist egalitarianism eroded labor productivity, are encouraging enterprise managers to reward workers for superior skills and performance. Last year, some industrial enterprises, on a trial basis, were allowed to float their total wage funds upward or downward on the basis of the amount of profits earned and the amount of taxes delivered to the state. In July 1985, Beijing announced a wage-reform package for teachers and government workers in which wages are to be based on the employee's position, seniority, and performance. []

Wage reforms ran into serious snags last year. Unauthorized across-the-board wage hikes for factory workers contributed to inflation and undermined efforts to link remuneration to performance. Wage

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reforms for teachers and government workers fell almost a year behind the original timetable, delayed, we believe, by budget concerns and resistance from employees, who fear they will lose out if skills and positions are rated over seniority as salary criteria.

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Reformers discovered that the policy of allowing an enterprise's wage fund to float on the basis of profitability was seriously flawed by China's irrational price structure. Enterprises selling goods at high state-set prices were able to make large profits in 1985, even if their efficiency was low, while enterprises required to sell goods at low state-set prices had difficulty earning profits, even if their labor productivity rose.

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Foreign Trade Reforms

Beijing significantly reduced central control over foreign trade in 1984. City and provincial governments were given greater authority to deal with foreign firms, and Chinese foreign trade enterprises were allowed to operate as commissioned agents for manufactures and importers of most products. Some of China's key state enterprises were granted independent authority to sign contracts for technological transformation projects, joint ventures, and compensation trade operations.

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We believe Beijing hoped the reforms would increase the stake that Chinese enterprises have in the trade process and thereby improve the timeliness and quality of imports and exports. The relaxed controls, however, caused the trade balance to deteriorate sharply last year, and competition among local trade organizations caused a decline in the export prices of some Chinese goods. Since April 1985, Beijing has recentralized its trade apparatus and tightened restrictions on foreign exchange use.

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